Internal Revenue Service

memorandum

TL-N-4209-89
JLRICKS

date: JUN 1 1989

to: Fera Wagner, Savings & Loan Industry Counsel,
Los Angeles, CA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

---

subject [redacted]
Request from Los Angeles Appeals

This tax litigation advice is in response to your memorandum dated February 27, 1989, regarding an assessment of the hazards of litigation of the points issue in the above-referenced case.

ISSUE

Whether a savings and loan can defer points charged to a borrower in connection with the origination of a real estate mortgage loan, where the savings and loan, as a result of advice received in a National Office Technical Advice Memorandum, modified the language used in [redacted] of its loan documents to reflect that points will be financed and where the substance of the transaction is not inconsistent with the form of the transaction?

CONCLUSION

A savings and loan can properly defer points charged to a borrower in connection with the origination of a real estate mortgage loan where the language used by the savings and loan in numerous loan documents specifically notifies the borrower that the points will be financed and where the substance of the transaction is not inconsistent with the form of the transaction.

FACTS

During the audit of [redacted]'s tax returns for the tax years [redacted] through [redacted],1/ Examination determined that [redacted] (1) incorrectly deferred their points income and (2) incorrectly reported this income under the loan liquidation method on the [redacted] loans closed from [redacted], through [redacted]. Examination

---

1/ [redacted] merged into [redacted], a Federal Savings Bank, on [redacted].

has proposed that the points charged by [redacted] on loans closed from [redacted] through [redacted], should be included in the taxable income in year [redacted] in their entirety.

[redacted] appealed the proposed adjustment made by Examination to the Los Angeles Appeals Office. The Appeals officer has submitted a request for technical advice regarding whether the [redacted] documents are sufficient to allow the taxpayer to amortize the points using the loan liquidation method. This request, hereinafter "the second request", is pending in the Office of Chief Counsel (Income Tax and Accounting). IT&A has requested that the second request for technical advice be withdrawn. The Appeals Officer then requested the involvement of the Savings and Loan Industry Counsel in this matter. The Savings and Loan Industry Counsel has asked our advice regarding our assessment of the hazards of litigating this issue.

During the period under audit, [redacted] reported its income using the cash receipts and disbursements method of accounting. Its principal source of income was interest income received from loans secured by deeds of trust on real property. During the period under audit, [redacted] reported its points income for tax purposes when realized under the loan liquidation method. The IRS previously authorized the company to use this method in a letter dated [redacted]. However, in a National Office Technical Advice Memorandum dated [redacted], issued by the Corporation Tax Division (hereinafter "the first Technical Advice Memorandum") the Service revoked the [redacted] ruling for tax years beginning after [redacted].

The first Technical Advice Memorandum focused on the terms of the agreement between the lender and the borrower to determine whether the lender and the borrower had agreed to either a financing of the loan charges (defined in the first Technical Advice Memorandum as points, prepaid interest, and service fees) or a payment of the loan charges at closing. The first Technical Advice Memorandum provided that if the parties agreed to finance the loan charges, the lender could defer the recognition of such charges into income until each payment of the loan charges was received. However, if the parties agreed that the loan charges would be paid at closing, these charges were to be included in the lender's gross income in the taxable year of the closing.

The first Technical Advice Memorandum also stated that the mere fact that the lender disburses a net check was insufficient by itself to establish an agreement of the parties to finance the loan charges. The Service also noted that most borrowers consider a portion of the cash they bring to closing to be applied against the portion of the points charge which constitutes interest. In addition, borrowers consider the transaction to fall within the scope of Rev. Rul. 69-188, 1969-1 C.B. 54. Accordingly, in the absence of clear language in the

loan documents, the Service would find that the loan charges were required to be paid at closing, which is the common practice in the industry.

In response to the first Technical Advice Memorandum, [redacted] revised the loan documentation it utilized in [redacted] as follows:

1. The Residential Loan Application and Addendum contains a specific section called "[redacted]." This section states that the:

[redacted]

. . . .

[redacted]. (Emphasis added).

This addendum is separately executed by the borrower at the time of submission of the financial data contained in the loan application.

2. The loan commitment letter, which is provided by [redacted] to the borrower before the borrower remits funds into escrow, was revised to reflect that points (referred to in [redacted] loan documents as "loan fees") are to be financed as follows:

[redacted]

[redacted]

3. In the lender's instructions to the escrow agent, [redacted] has listed as one of its requirements that:

[redacted]

The lender's instructions then went on to specify that the "Financed and Deducted Loan Costs" included the "Loan Fee", among other fees.

4. In addition, [redacted] provided a document called the "Discount Loan Statement", which exclusively addressed the financing of the loan fees. The document, which is signed by both [redacted] and the borrower, confirms that certain costs including the loan fee,

[redacted]

[redacted]

It is the position of [redacted] that it acted in good faith and in accordance with the first Technical Advice Memorandum when it revised its loan documents to clearly state that (1) the loan fees are to be financed and deducted from the loan proceeds and (2) that the lender does not have the right to require payment of the financed costs from any source other than the loan proceeds. Since the Service has never published any ruling stating the specific language or the documentation that is required to advise the borrower that the loan fees are to be financed, [redacted] argues that it substantially complied with the first Technical Advice Memorandum.

Moreover, Roger Clough, the Appeals officer working this case, has informed us that the substance of the loan transactions is not inconsistent with the form of the loan documents.

DISCUSSION

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income of the taxpayer for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Under the cash receipts and disbursements method of accounting, items of income are includible in the gross income of the taxpayer when actually or constructively received. Treas. Reg. § 1.451-1(a). Under the accrual method of accounting, "income is includable in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Id.

In Rev. Rul. 70-540, 1970-2 C.B. 101, the Service takes the position that since points are compensation for the use or forbearance of money, they are interest. Section 461(g)(1) expresses the general rule that a cash basis taxpayer must deduct prepaid interest in the period to which it is properly allocable. Section 461(g)(2), however, sets forth an exception to this general rule. Section 461(g)(2) provides that points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer may be deducted in full in the year of such payment and need not be allocated to any other period. Where section 461(g)(2) applies (because the borrower actually has paid the points), it follows that the lender would be required to include in income the points paid by the borrower.

Rev. Rul. 70-540, amplified, Rev. Rul. 74-607, 1974-2 C.B. 149, discusses several factual situations in which the borrower is charged points and service fees and the Service's position as to when the lender must include these items into gross income. In Situations (1) and (4) of Rev. Rul. 70-540, respectively, the borrower pays the points or service fees at closing with his own ("fresh") funds which are not originally obtained from the lender. Rev. Rul. 70-540 holds that these charges are included in the lender's gross income in the year the payment was actually received unless, under the accrual method, the taxable year the right to receive the payment arose is earlier than the taxable year of receipt. Whether the lender actually received payment out of the fresh funds of the borrower or assigned the right to receive such payment to another party (either the seller or the escrow agent) by collateral agreement is irrelevant. The Service has taken the position that, under the assignment of income principles of Helvering v. Horst, 311 U.S. 112 (1940), Situations (1) and (4) of Rev. Rul. 70-540 are equally applicable to cases of constructive receipt. G.C.M. 37627 (July 31, 1978), revoked, G.C.M. 39087 (Dec. 2, 1983), reconsidered and affirmed in unnumbered G.C.M., [redacted]

(Feb. 5, 1986) (affirmed the conclusions reached in G.C.M. 37627) [hereinafter referred to as "[redacted] G.C.M."]. This position is also taken in the proposed points revenue ruling, Control No. TR-33-121186-83 (3L 1186)(hereinafter "proposed points revenue ruling") 2/.

If the parties instead agreed to finance the points and/or service fees and discount them from the face of the loan,3/ a lender can defer the recognition of such charges into gross income. Rev. Rul. 70-540, supra, Situations (2) and (5). If the lending institution uses the cash receipts and disbursements method of accounting, Situations (2) and (5) of Rev. Rul. 70-540 provide that the points and service fees are includable by the lender in gross income ratably as payments on the note are made by the borrower. If the lending institution uses an accrual method of accounting, the points are includable in the gross income of the lender ratably as payments on the note are due or actually received, if earlier. Rev. Rul. 74-607, 1974-2 C.B. 149. Yet, the service fee is includible in the gross income of an accrual method lender in the tax year the loan is made, since all the events have occurred which fix the lender's right to receive the income and the amount is determinable.

It is the Service's position that the agreement between the borrower and the lender should control the determination whether points are regarded as paid for tax purposes. [redacted] G.C.M., supra. The case law in this area supports this view. See, e.g., Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982); Wilkerson v. Commissioner, 655 F.2d 980 (9th Cir. 1981); Battelstein v. Commissioner, 631 F.2d 1182 (5th Cir. 1980) (en banc), cert. denied, 451 U.S. 938 (1981); Schubel v. Commissioner, 77 T.C. 701 (1981). Thus, even though the lender's ultimate cash position will be identical in the situations where the borrower pays the loan charges outright at closing to the lender or the lender agrees to finance such charges (assuming the total amount of the loan is the same in both cases), 4/ different tax consequences

---

2/ The proposed points revenue ruling is presently undergoing a second policy review.

3/ For example, if the loan is for $30,000 and the points are $3,000, the note will be written for $30,000 and the lender will disburse $27,000 to the borrower.

4/ For example, where the borrower pays the $1,000 loan charges with his own funds, executes a note payable to the lender for $20,000 and the lender disburses $20,000 to the seller, the lender has a net cash outflow of $19,000. The lender will also have a net cash outflow of $19,000 where the borrower borrows the $1,000 loan charge from the lender, executes a note payable to the lender for $20,000 and the lender disburses $19,000 to the

should result in accordance with the agreement of the parties. [redacted] G.C.M., supra, at [redacted].

We believe that to determine whether there was an agreement between the parties to finance the loans, the mortgage loan documents and the surrounding circumstances should be examined. Among the relevant circumstances is the extent to which the parties conduct themselves consistently before, during, and after the closing in identifying the source from which the points and service fees were paid. This position was taken in the proposed points revenue ruling, supra.

The mere fact that the lender disburses a net check (i.e., the face amount of the note less the loan fees) is insufficient by itself to establish an agreement of the parties to finance the loan charges. A net disbursement creates an ambiguity in that such a disbursement is not inconsistent with an agreement to finance the loan fee, but could also be indicative of the assignment of the loan fee by the lender to the seller. Because the existence of a net disbursement is not determinative, a factual determination must be made whether the lender and the borrower agreed to finance the loan fee or, alternatively, whether both parties understood (i) that such fee would be paid by the borrower with his own funds at the loan closing or (ii) that the lender possessed the right to demand such payment. G.C.M. 37627; [redacted] G.C.M., supra, at [redacted]. This agreement respecting payment of the loan fee, where not clearly expressed, is established from a review of the loan documents, as well as from the circumstances surrounding the loan negotiations, including the common understanding of the parties of the established practice in the industry. [redacted] G.C.M., supra, at [redacted].

Based on the foregoing discussion, our position is that if the borrower is required to furnish, and does furnish at closing, his own funds in sufficient amount to satisfy the points and service fees, those charges are includable in the gross income of the lender for the tax year of the loan closing, unless the circumstances indicate that the points and service fees were financed and deducted from the mortgage loan proceeds. In general, if the agreement to finance the points is not contained in all of the relevant documents (e.g., the loan application, loan commitment letter, separate statement attached to a loan disclosure statement and a separate statement attached to the final closing statement), the parties have not clearly and consistently agreed to finance the points. If the parties do not clearly and consistently agree to finance the points, the Service

---

seller. In the latter situation, of course, the borrower pays an additional $1,000 to the seller from his separate funds.

will treat the points as being paid by the borrower from his separate funds.

In the instant case, the various loan documents clearly reflect an agreement between the borrower and lender to finance the points. The Residential Loan Application and Addendum, the loan commitment letter, and the Discount Loan Statement make clear that: (1) [redacted] will finance the points and/or service fees and deduct these items from the loan proceeds; (2) that [redacted] will only pay the points and/or service fees from the loan proceeds and no other sources; and (3) that since the points will be financed and deducted, the borrower will need to provide additional funds to satisfy the balance of the purchase price to the seller. This agreement was contained in most of the relevant documents, as stated above. Two of the documents, the loan application and the Discount Loan Statement, require the signature of the borrower. Moreover, the substance of the transaction is not inconsistent with an agreement to finance the points. Under these circumstances, the agreement was set forth in sufficient relevant documents that it is very likely that a court would hold that an agreement to finance existed between the parties.

The Appeals officer pointed out that the loan documents lack an explanation describing the income tax consequences to the borrower resulting from a financing of the loan documents. In the proposed points revenue ruling, the Service has included sample language which it considers to be sufficient to show an agreement to finance the points between the borrower and the lender. The Service's proposed language contains a statement describing the tax consequences of the financing of such charges to the borrower as follows:

> It is the position of the Internal Revenue Service in Rev. Rul. ____*____ that in such event the borrower will not be allowed to deduct the total amount of any points charge for the tax year of the loan closing but will be entitled to deduct it over the life of the loan as mortgage payments are made.

It is true that the Service is more inclined to find an agreement to finance where there is language in the loan documents describing the income tax consequences to the borrower of financing the points. Such language indicates that the borrower was aware of the federal income tax consequences of financing the points. The underlying loan documents are persuasive evidence that the borrower and the lender consistently identified the loan proceeds as the source from which the points were paid and that they were indeed financed.

However, the absence of such language does not indicate that there is no agreement to finance. The first Technical Advice

Memorandum issued to [redacted] did not state that the inclusion of a discussion of tax consequences to the borrower in the loan documents was an indication of an agreement to finance. Considering the other language used in four loan documents, which clearly express an agreement to finance the points, a court will most likely find an agreement to finance between the lender and borrower, even though the tax consequences to the borrower are not expressly stated.

Had the points issue been tried and the Service had won a few of the more egregious cases, we might recommend pursuing this case. However, given the unambiguous wording in four loan documents that [redacted] was to pay the loan fees solely from the loan proceeds, we believe that [redacted] should not be one of the first cases in this area to be litigated.

There are substantial hazards of litigating this case, as described above. Because these hazards are great, we recommend that the Service concede the issue in the instant case.

This tax litigation advice was coordinated with Branch 1, Tax Litigation Division and the Office of Assistant Chief Counsel (Income Tax and Accounting). If you have any questions regarding this tax litigation advice, please contact Jo Lynn L. Ricks at FTS 566-3350.

MARLENE GROSS

By: _____
Pamela V. Gibson
Special Counsel (Tax Shelters)